85-1805

No. -

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

ALEXANDER ROSS; JAMES L. MELCHER; IVAN BLOCH; VINCENT GIOVINCO; BRUCE MALE; FREDERICK M. MYERS; JOHN C. FITCH; and LEWIS W. SIEGEL, individually and as representative of all other similarly situated,

Petitioners,

vs.

AFP IMAGING CORPORATION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE PETITIONERS

H. MILES JAFFE
RAGGIO, JAFFE & KAYSER
A member of the Bar of the Supreme
Court and Counsel of Record
for Petitioners
10 East 40th Street
New York, New York 10016
(212) 689-6850

Attorneys for Petitioners

Question Presented

Is an arbitration clause contained in a contract negotiated at arm's length between parties of equal bargaining strength, and providing for the sale of all of the shares of a corporation, enforceable with respect to a party's claim under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5?

List of All Parties

Petitioners - The following parties are named in the caption of the action: Alexander S. Ross; James L. Melcher; Ivan Bloch; Vincent Giovinco; Bruce Male; Frederick M. Myers; John C. Fitch; and Lewis W. Siegel, individually, and as a representative of a class of defendants.*

Respondent - AFP Imaging Corporation.

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* The following parties, none of which have been served with process, would constitute the putative class of defendants if the action is permitted as a defendant class action: Larry Abrams; John Ashmon; CEPO, Ltd.; Peter Friedman; Kenneth Fretter; Nathan Gantcher; Barbara Guernsey; James H. Hunter; James M. Hunter; Richard Hunter; Penny Kaniclides; Geraldine Koretsky; Gerald Levine; Albert Magill, Jr.; First & Merchants National Bank as Agent for Anne Holt Massey, Surviving Trustee; Mrs. Anne Holt Massey; Holt Massey; Christopher R. Myers; Frederick M. Myers, III; George Peterkin; Mort Rapp; Marilyn Ross; Fayez Sarofim; Lawrence Schafran; Edith D. Siegel; Elizabeth I. Solomon; Susan Thompson; TRI-R Byproducts; and Claude K. Williams.

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No. ...-.....

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1985

ALEXANDER ROSS; JAMES L. MELCHER; IVAN BLOCH; VINCENT GIOVINCO; BRUCE MALE; FREDERICK M. MYERS; JOHN C. FITCH; and LEWIS W. SIEGEL, individually and as representative of all other similarly situated,

Petitioners,

vs.

AFP IMAGING CORPORATION,

Respondent.

MEMORANDUM FOR THE PETITIONERS

Opinions Below

The opinion of the court of appeals (Pet. App. A-1 - A-7) is reported at 780 F.2d 202 (2d Cir. 1985).

The order of the court of appeals dated February 3, 1986 (Pet. App. A-23 - A-24) denying a petition for rehearing without opinion is not reported.

The Decision and Order (Pet. App. A-8 - A-19) and the Final Judgment (Pet. App-20 - A-22) of the district court are not reported.

Jurisdiction

The decision and order of the Court of Appeals was dated December 23, 1985 and entered on that date. The order of the Court of Appeals, denying a petition for rehearing was dated February 3, 1986 and entered on that date.

Jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Statutes Involved[1]

1. United States Arbitration Act 9 U.S.C. §§2 and 3 (See Pet. App. A-38 - A-39 for text).

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1. Texts of the pertinent provisions are set forth in the appendix at pages A-38 - A-42.

2. Securities Exchange Act of 1934, 15 U.S.C. §78j(b), §78aa, and §78cc (See Pet. App. A-40 - A-42 for text).

Statement Of The Case

This is an action brought by a New York Corporation, AFP Imaging Corporation ("AFP"), under §10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. §78j(b), and Securities & Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5, against seven individuals who were shareholders and directors of a second corporation Xenon Industries, Inc. ("Xenon") and an eighth individual shareholder, individually and as a representative of a putative class of 29 former shareholders of Xenon. The action was commenced in the United States District Court, Southern District of New York, under the jurisdictional provisions of

the 1934 Act.[2]

By a written contract dated August 8, 1984 between AFP and Xenon, Xenon agreed to "cause the sale" of all of its capital stock to AFP in exchange for AFP stock. Pursuant to the agreement, the transfer took place and the shareholders of Xenon received AFP stock. Alleging fraudulent misrepresentations in the written contract, AFP brought this action against the former shareholders of Xenon.

The August 8, 1984 contract contained an arbitration clause, section 24, which provides:

> "All controversies arising under or in connection with, or relating to any alleged breach of the Agreement shall be settled by arbitration in New York, New York, in accordance with the rules of the American Arbitration Association then in

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2. The action by AFP initially contained a common law claim which was withdrawn.

> effect and judgment under any award rendered may be entered in any court having jurisdiction."

The question before this court is the right of the individual shareholder defendants to enforce this arbitration clause (against the purchasing corporation) as to the claim under the 1934 Act.

Defendants moved the District Court to compel arbitration of AFP's claims and for summary judgment. The District Court (Brieant J.) dismissed the federal security law claim on a motion for summary judgment. On appeal, the Second Circuit Court of Appeals, finding that there was a triable issue of fact, remanded with a further holding that the arbitration clause, even in this context, was, as to the federal security law claims, unenforceable.[3]

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3. The issue of arbitration was not briefed before the Second Circuit. A petition for rehearing with a

The defendants seek review by this Court of their right to arbitration.

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suggestion for rehearing en banc was brought to address the arbitration question. That petition was denied without opinion. However, in a case decided by the Second Circuit two months after the rehearing was denied, Eugene McMahon et al., v. Shearson/American Express, Inc. et al., Nos. 806,894 slip op. (2d Cir. April 16, 1986) (see Pet. App. A-25 - A-37 for text of opinion in that case), the Second Circuit cited this case as one in which it has "held" that claims under the 1934 Act were not arbitrable. The clarification in McMahon that the arbitration issue had been decided on the merits necessitated the bringing of this petition.

ARGUMENT

THE REASONS FOR REVIEW

In deciding that an arbitration clause is not enforceable in respect to a Section 10(b) claim,[4] the United States Court of Appeals for the Second Circuit has decided an important question of federal law which this Court has recognized as an open question. See Dean Witter Reynolds, Inc. v. Byrd, ____ U.S. ____, 105 S.Ct. 1238, 1240 n.1, 84 L.Ed.2d 158 (1985). The Second Circuit acknowledges this to be an open question before his Court. AFP Imaging Corp. v. Ross, 780 F.2d 202, 205 (2d Cir. 1985).

As amplified below, the question presented for review in this case must be

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4. As used herein, the term Section 10(b) claim refers to claims by private parties under §10(b) of the 1934 Act and/or Rule 10b-5 of the Securities & Exchange Commission.

settled by this Court because of:

(a) the reluctance of lower courts, notwithstanding the clear mandate of the United States Arbitration Act and this Court's decision in Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., _____ U.S. _____, 105 S.Ct 3346 (1985), to enforce private agreements to arbitrate and to accept arbitration as a proper forum for the resolution of disputes, even between parties of equal bargaining power, who have agreed to utilize this forum;

(b) the diversity of results being reached by lower courts, all applying the same federal laws; and

(c) the substantial impact of the question on the clogged dockets of the federal courts and the escalating cost to all litigants resulting from appeals

involving this procedural question alone which prevents courts from reaching the merits of disputes.

1. **The Defendants Are Being Denied Their Right To Enforce An Arbitration Agreement**

The United States Arbitration Act expressly states that:

> "a written provision in . . . a contract evidencing any transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable." 9 U.S.C. §2

In Scherk v. Alberto - Culver Company, 417 U.S. 506, 512-513, 94 S.Ct. 2449, 41 L.Ed.2d 270 (1974), this Court stated:

> "The United States Arbitration Act, now 9 U.S.C. §1 et seq., reversing centuries of judicial hostility to arbitration agreements, was designed to allow parties to 'avoid the costliness and delays of litigation,' and to place arbitration agreements, 'upon the same footing as other contracts.'"

This Court reinforced this position in Dean Witter Reynolds, Inc. v. Byrd, supra, and stated:

> "The preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate," at 1242-43.

In Wilko v. Swan, 346 U.S. 347, 74 S.Ct. 182, 98 L.Ed.2d 168 (1953), with respect to a form agreement between a brokerage house and a customer, this Court held that claims under §12(2) of the Securities Act of 1933, 15 U.S.C. §§77 ("1933 Act") were non-arbitrable. Despite the distinctions between the 1933 Act and the 1934 Act noted in this Court's opinions in Scherk, supra, 417 U.S. at 513 and Byrd, supra, at 105 S.Ct. at 1240 and the requirement set forth in Mitsubishi, supra, 105 S.Ct. at 3355 that

to deny arbitration a court must find that Congress specifically intended to except arbitration, the Second Circuit has extended the Wilko rationale to claims under §10b of the 1934 Act. As expressed by Justice White in his concurrence in Byrd:

> "The premise of the controversy before us is that respondent's claims under the Securities Exchange Act of 1934 are not arbitrable, notwithstanding the contrary agreement of the parties. The Court's opinion rightly concludes that the question whether that is so is not before us. Ante, at 1240, n. 1. Nonetheless, I note that this is a matter of substantial doubt. In Wilko v. Swan [cite omitted], the Court held arbitration agreements unenforceable with regard to claims under §12(2) of the 1933 Act. It relied on three interconnected statutory provisions: §14 of the Act, which voids any 'stipulation . . . binding any person acquiring any security to waive compliance with any provision; of the Act; §12(2), which the Court noted, created 'a special right to recover for misrepresentation which differs substantially from the common-law action;' and §22, which allows suit in any state or federal court of competent jurisdiction and provides for

nationwide service of process. 346 U.S., at 431, 434-435, 74 S.Ct., at 194, 196; 15 U.S.C. §§77n. 771(2), 77v.

Wilko's reasoning cannot be mechanically transplanted to the 1934 Act. While §29 of that Act, 15 U.S.C. §78cc(a), is equivalent to §14 of the 1933 Act, counterparts of the other two provisions are imperfect or absent altogether. Jurisdiction under the 1934 Act is narrower, being restricted to the federal courts. 15 U.S.C. §78aa. More important, the cause of action under §10(b) and Rule 10b-5, involved here, is implied rather than express. See Herman & MacLean v. Huddleston, 459 U.S. 375, 380, and nn. 9-10, 103 S.Ct. 683, 686-87, and nn. 9-10, 74 L.Ed.2d 548 (1983). The phrase 'waive compliance with any provision of this chapter,' 25 U.S.C. §78cc(a) [emphasis added in original], is thus literally inapplicable. Moreover, Wilko's solicitude for the federal cause of action -- the 'special right' established by Congress, 346 U.S., at 431, 74 S.Ct., at 184 -- is not necessarily appropriate where the cause of action is judicially implied and not so different from the common law action. [Footnote omitted]

The Court has expressed these reservations before. Scherk v. Alberto-Culver Co., 417 U.S. 506, 513-514, 94 S.Ct. 2449, 2454, 41 L.Ed.2d 270 (1974). I reiterate them to emphasize that the question remains open and the contrary

> holdings of the lower courts must be viewed with some doubt." 105 S.Ct. at 1244.

Most recently, in Mitsubishi, this Court, cited Justice White's concurring opinion in Byrd with apparent approval, stating:

> "Just as it is the congressional policy manifested in the Federal Arbitration Act that requires courts liberally to construe the scope of arbitration agreements covered by that Act, it is the congressional intention expressed in some other statute on which the courts must rely to identify any category of claims as to which agreements to arbitrate will be held unenforceable . . . Dean Witter Reynolds Inc., ____ U.S., at _____, 105 S.Ct., at 1239-40 (concurring opinion)" at 3355. (emphasis added)

Based on Mitsubishi, it would seem that this court has rejected the Second Circuit's view and would compel arbitration of the Section 10(b) claims unless it were to find that Congress has expressed its intention in the 1934 Act to exclude such claims from arbitration

-- an intention this Court has never found.

2. **Because The Arbitration Provision Arose In A Negotiated Arms Length Transaction, There Is Particular Reason To Enforce The Agreement To Arbitrate**

Because the contract containing the arbitration provision in this case was negotiated between sophisticated parties of equal bargaining power, each represented by competent and experienced counsel, this court has the opportunity to narrow Wilko without finding all Section 10(b) claims to be arbitrable. Generally, the cases relating to the arbitrability of Section 10(b) claims have arisen out of non-negotiated standard-form brokerage agreements.[5]

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5. See for example Wilko v. Swan, 346 U.S. 427 (1953) (Brokerage form agreement); Zemaitis v. Merrill Lynch, Pierce, Fenner & Smith, 583 F.Supp. 1552 (S.D.N.Y. 1984) (Brokerage firm Standard Option

There are substantial distinctions between the standard broker-customer agreement and the arms length negotiated contract found here. The public policy interest in protecting parties with less economic power and of preventing potential injustices created by adhesion contracts are not present in these circumstances. Justice Stevens, then sitting in the Circuit Court for the 7th Circuit Court of Appeals, in his dissenting opinion in Scherk v. Alberto-Culver Company, 484 F.2d 611 (7th Cir. 1973), reversed 417 U.S. 506,

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Agreement); Fischer v. New York Stock Exchange, 408 F.Supp. 745 (S.D.N.Y. 1976) (Custodial account lending agreement with a brokerage firm); and Stockman v. Seroussi, 377 F.Supp. 518 (S.D.N.Y. 1974) (Brokerage firm's customer's margin agreement signed when account opened).

94 S.Ct. 2449, 41 L.Ed.2d 270 (1974) (given greater weight due to the reversal of the majority opinion by this Court), set out distinctions which are appropriately applied to the facts in the case at bar:

> "But with the application of Rule 10(b)5 to negotiated transactions in which the amount at stake typically justifies an independent audit or other verification of the property being purchased or sold, and the transfer of securities is a function of the form in which the parties elect to cast their transactions, quite different considerations apply. To the extent that reliance on statutory protection plays a relatively less significant part in the investment decision, there is a correspondingly lesser justification for a prohibition against any waiver of the benefits of the Act. Moreover, in transactions which are sufficiently large and complex that the parties typically contemplate the possibility of future controversy, the method of resolving foreseeable disputes is itself a proper subject of bargaining." at 617.

Commentators also generally subscribe to Justice Stevens' opinion. See Agreements to Arbitrate, 2 Cardozo L.

Rev., 481, 516-521 (1981), which supports the proposition that freely negotiated arbitration agreements of the type in the case at bar should be enforced in connection with the federal securities laws.

3. The Decision Of The Court Of Appeals Requires An Exercise Of This Court's Power of Supervision

The holding by the Second Circuit in this case appears to conflict with this Court's recent decision in Mitsubishi, supra. Although Mitsubishi concerned the right to arbitrate claims raised under the Antitrust laws, the analysis by this Court in that case would appear to mandate a contrary result in this case.

The division of authority and resulting confusion is not restricted to the Second Circuit. Numerous district courts confronted with this important issue have decided that Section 10(b)

claims are arbitrable, concluding that prior precedent to the contrary is no longer viable in light of this Court's analysis and decisions in Byrd and Mitsubishi. Many other district courts have continued to apply the principles of Wilko to 1934 Security Act claims,[6] and it is for this reason, if no other, that clarification is needed from this Court.

Furthermore, the Second Circuit continues to reaffirm its commitment to the position that Section 10(b) claims are not arbitrable. Subsequent to this case in Eugene McMahon et al. v. Shearson/American Express, Inc. et al.,

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6. The Securities Industry Association has reported that between the Byrd decision and March 31, 1986, 64 district courts have found arbitration clauses enforceable in face of Section 10(b) claims while 28 have held to the contrary. Arguments have been held and cases are sub judice in the Third and Ninth Circuits.

No. 806,894 (2d Cir. April 16, 1986) (Pet. App. A-25 - A-37). That court, referring explicitly to this case, stated that it had "held" here that Section 10(b) claims are not arbitrable[7] and asserted again such was the law in the Second Circuit. The holding here is a clear expression of policy by that court and is in direct conflict with holdings of other courts and analysis set forth by this Court.

4. A Ruling That Section 10(b) Claims Are Arbitrable Could Relieve Federal Court Dockets

Statistics compiled by the Administrative Office of the U.S. Courts show that during the twelve months ended March 31, 1984, a total of 3,046

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7. Shearson/American Express, Inc. has stated its intention to file a petition for certiorari to review the Second Circuit's holding in that case within the next 30 days.

"Securities and Commodities Exchange" civil actions were filed in federal district courts.[8] If this Court accepts this case and holds that Section 10(b) claims are arbitrable, it can be reasonably expected that a substantial portion of such actions would be submitted to arbitration in accordance with the agreements made between the parties.

Conclusion

A review of the issue in the instant case by this Court will resolve an important question of federal law concerning the right of contracting parties to arbitration, address a matter of considerable importance to both the securities industry and the general public,

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8. See Federal Judicial Workload Statistics (March 31, 1984).

promote consistent decisions in cases with similar facts in the district courts, and constitute a proper and necessary exercise of the Court's power of supervision. For these reasons, petitioners respectfully request this petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit be granted.

Dated: May 1, 1986

Resepectfully submitted,

H. MILES JAFFE
RAGGIO, JAFFE & KAYSER,

A member of the Bar of the Supreme Court and Counsel of Record for Petitioners.

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Cal. No. 175—August Term, 1985

(Argued October 9, 1985 Decided December 23, 1985)

Docket No. 85-7494

AFP IMAGING CORPORATION,

Plaintiff-Appellant,

—v.—

ALEXANDER ROSS, JAMES L. MELCHER, IVAN BLOCH, VINCENT GIOVINCO, BRUCE MALE, FREDERICK M. MYERS, JOHN C. FITCH, and LEWIS W. SIEGEL, Individually and as representative of all others similarly situated,

Defendants-Appellees.

Before:

FEINBERG, *Chief Judge*,
VAN GRAAFEILAND and MESKILL, *Circuit Judges*.

Appeal from a summary judgment of the United States District Court for the Southern District of New York

(Brieant, J.) which dismissed a Count alleging securities fraud and ordered arbitration of two common law claims. Dismissal of securities fraud Count reversed and matter remanded to the district court for further proceedings. Direction to arbitrate affirmed in part and vacated in part without prejudice.

STUART A. SUMMIT, New York, N.Y. (Burns Summit Rovins & Feldesman, New York, N.Y. of Counsel), *for Plaintiff-Appellant.*

LEO KAYSER, III, New York, N.Y. (Raggio, Jaffe & Kayser, New York, N.Y., of Counsel), *for Defendant-Appellees.*

ANTHONY E. DAVIS, New York, N.Y. (Kaplan Russin Vecci Kirkwood, New York, N.Y., of Counsel), *for Defendant-Appellee Alexander Ross.*

VAN GRAAFEILAND, *Circuit Judge*:

AFP Imaging Corporation appeals from a summary judgment of the United States District Court for the Southern District of New York (Brieant, J.). The judgment dismissed Count I of AFP's partial-defendant class action complaint, which alleges violation of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.

§ 78j(b), and Rule 10b-5 of the Securities & Exchange Commission's Rules, 17 C.F.R. § 240.10b-5, and directed arbitration of the remaining issues between the parties. For the reasons that follow, we reverse the part of the judgment that dismissed the securities fraud claim, affirm the part that ordered arbitration of the claim of appellant Ross, and vacate and remand the remainder of the judgment without prejudice.

AFP and Xenon Industries, Inc. are New York corporations. The members of the putative defendant class are the twenty-nine shareholders of Xenon. On August 8, 1984, AFP and Xenon executed a written contract, which provided, among other things, that Xenon would "cause the sale" of all the shares of its capital stock to AFP and would transfer all the shares to AFP on the closing date "duly endorsed for transfer". The agreed consideration for this sale was 225,000 letter shares of AFP stock plus warrants for an additional 400,000 shares. AFP now seeks to hold Xenon's shareholders responsible under both the securities laws and the common law for alleged fraudulent misrepresentations in the written contract. It demands the return of its stock, damages, and certain incidental relief.

Although the contract described Xenon as the "seller" of its stock, the district court stated that Xenon was not the seller and that it was appellees who sold their stock pursuant to the contract. We agree. New York follows the majority American rule, which treats shares of stock as the personal property of the shareholders. *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 540-41 (1957). Obviously, a New York corporation, acting solely on its own, cannot "cause" the sale of all its corporate shares for a consideration fixed by the corporation.

There is no reason, however, why Xenon could not have acted as appellees' agent in effecting the sale of their stock. Although, ordinarily, a corporation does not act in the capacity of agent for its shareholders, *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 440 (1943), the shareholders may involve the corporation in their own business affairs to such an extent as to constitute it their agent. *Hollander v. Henry*, 186 F.2d 582, 584 (2d Cir.), *cert. denied*, 341 U.S. 949 (1951); *Walkovszky v. Carlton*, 18 N.Y.2d 414, 417 (1966); *Rapid Transit Subway Construction Co. v. City of New York*, 259 N.Y. 472, 488 (1932). A jury well might find that this is what occurred in the instant case.

Because Xenon was not the seller and could not unilaterally effect the sale of its own stock, a jury might conclude that Xenon was acting in some sort of representative capacity for appellees, who were the sellers and who clearly benefited from Xenon's acts. Moreover, it is undisputed that appellees accepted those benefits with full knowledge of the warranties and representations contained in the written contract of sale. Each appellee was required to execute and deliver to AFP an "Investment Representation Letter", in which he acknowledged that he had received and reviewed a copy of the contract. We conclude from the foregoing that this case presents factual issues concerning apparent and implied authority, authority by estoppel, and ratification, that do not lend themselves to summary disposition. *See Hedeman v. Fairbanks, Morse & Co.*, 286 N.Y. 240, 248-49 (1941); *Cavic v. Grand Bahama Development Co.*, 701 F.2d 879, 887 n.4 (11th Cir. 1983); *Songbird Jet Ltd. v. Amax Inc.*, 581 F. Supp. 912, 920 (S.D.N.Y. 1984); *Cullen v. BMW of North America, Inc.*, 490 F. Supp. 249, 252-54 (E.D.N.Y.

1980). If, in fact, Xenon was acting as appellees' agent in making what AFP alleges to be false warranties and representations, appellees, having accepted the benefits with knowledge of the inducements, will be hard put to disassociate themselves from Xenon's allegedly wrongful acts. *See American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 565-70 (1982); *Weitnauer Trading Co. v. Annis*, 516 F.2d 878, 880 (2d Cir. 1975); *Radiation Dynamics, Inc. v. Goldmuntz*, 323 F. Supp. 1097, 1099 (S.D.N.Y. 1971), *aff'd*, 464 F.2d 876 (2d Cir. 1972).

Because of AFP's concession that it is relying on only the representations in the written contract, there is no need to comment on the district court's discussion concerning possible unwritten representations. Because we are reversing the district court's dismissal of the federal securities law claim, we likewise need not address AFP's argument that, as a result of the dismissal, the district court lost pendent jurisdiction to order arbitration. Finally, we agree with appellees that the district court's cursory reference to limitation of liability did not create an issue for this Court to consider. The district court, having found no liability, never reached the question whether a recovery by AFP would be limited to an escrow fund containing AFP stock, which was set up pursuant to the terms of the contract.

Although the contract provided that all controversies arising under or in connection with it would be settled by arbitration, this provision is, of course, unenforceable under the law of this Circuit insofar as the securities law claim is concerned. *Greater Continental Corp. v. Schechter*, 422 F.2d 1100, 1103 (2d Cir. 1970). *Cf. Dean Witter Reynolds, Inc. v. Byrd*, 105 S. Ct. 1238, 1240 n.1 (1985),

indicating that the Supreme Court considers this an open question. However, appellee Ross has a common law breach of contract claim against AFP, which is arbitrable. The contract of sale provided in substance that, as part of the deal, AFP and Ross would execute a three-year employment agreement upon terms and conditions acceptable to Ross. The agreement never was executed, but Ross went to work for AFP anyway and was discharged after he had been employed for less than six months. When AFP brought the instant action, Ross promptly demanded arbitration of his claim. AFP then sought an order staying the arbitration and directing Ross to assert his claim as a counterclaim in the action. The district court had no alternative but to deny this relief. *Dean Witter Reynolds, Inc. v. Byrd, supra*, 105 S. Ct. at 1241-42; *NPS Communications, Inc. v. Continental Group, Inc.*, 760 F.2d 463, 465-66 (2d Cir. 1985).

Because of the Supreme Court's unequivocal language in *Dean Witter, supra*, the district court also was bound to grant appellees' request for arbitration of AFP's claim of common law fraud. However, because AFP's counsel has assured this Court that, if the securities claim is remanded to the district court, AFP will withdraw its state law claim for fraud, we think it will simplify procedures if, instead of affirming, we vacate the part of the district court's judgment that orders arbitration of the state law claim, without prejudice to its immediate reinstatement if, upon remand, AFP fails to withdraw that claim promptly.

In summary, the decision and order of this Court is as follows:

1. The part of the district court's judgment that dismisses Count I of the complaint is reversed, and the issues alleged in that Count are remanded to the district court for further proceedings consistent with this opinion.

2. The part of the judgment that orders arbitration of the common law breach of contract claim of appellee Ross is affirmed.

3. The part of the judgment that orders arbitration of AFP's state law claim and enjoins litigation of this claim is vacated without prejudice to its reinstatement should AFP fail to withdraw this claim promptly upon remand.

APPENDIX B

MEMORANDUM AND ORDER

United States District Court, Southern District of New York.

AFP Imaging Corporation, Plaintiff, vs. Alexander Ross, et al., Defendants. No. 85 Civ. 1149-CLB.

Filed: 5/3/85

By motion docketed April 1, 1985, plaintiff in this "partial defendant class action" moves to stay arbitration on the ground that to permit arbitration to proceed as to pendent state law claims would require determination of plaintiff's non-arbitrable claims arising under the federal securities laws, coming out of the same series of transactions. See Allegaert v. Perot, 548 F.2d 432 (2d Cir. 1977) but cf. Dean Witter Reynolds v. Byrd, 53 U.S.L.W. 4222 (U.S. Supreme Court March 5, 1985). By motion

docketed April 4, 1985 defendants seek arbitration of those issues which are arbitrable, and to dismiss the federal non-arbitrable claims. Both motions were argued April 19, 1985 and it was agreed that the Court could consider defendants' motion to dismiss as one for Summary Judgment pursuant to Rule 56, F.R.Civ.P, rather than a Rule 12 or Rule 9(b) motion, as originally styled.

Defendants ("Sellers"), individually and as purported class representatives for parties similarly situated, are all former shareholders of Xenon Industries, Inc., a closely held New York corporation, (hereafter "Xenon"). Defendants sold their stock in Xenon to plaintiff ("AFP") for AFP shares on August 8, 1984 pursuant to a written agreement between Xenon and AFP which contemplated that thereafter Xenon, which apparently had a favorable tax loss

carry-forward for income tax purposes, would be merged with AFP, and it was.

The actual Agreement is before the Court (Ex. 1 to Melcher Affidavit), and its terms control the conclusory allegations in the Complaint. Although Xenon itself is described in the Agreement as the ("Seller") it is undisputed that it was not. Xenon merely agreed to "cause" the sale of all of its capital stock to AFP. It also agreed to deliver the resignations of all its directors and officers, and represented that "it will convey to Buyer [AFP] at the closing 100% of the legal and beneficial interest in the Business" (Agreement, ¶10). We note that at the closing each selling shareholder signed an "investment representation letter" (Ex. 1 to Myers Affidavit) which contained no warranties or representations concerning Xenon except that:

> "The undersigned has received a copy of the executed Agreement and has reviewed the provisions thereof including, in particular, the provisions relating to the Escrow Fund and the provisions relating to the restricted nature of AFP Securities to be received by the undersigned."

The agreement between Xenon and AFP contains a number of special warranties and representations by Xenon, typical of those found in an agreement for the sale of a going business to one intending to carry on the business for his own account, rather than to profit as an investor from the managerial efforts of others. Because the sale was structured as a sale of stock, the Golden doctrine of the Second Circuit is placed in issue. See Golden v. Garofalo, 678 F.2d 1139 (2d Cir. 1982) and Seagrave Corp. v. Vista Resources, 696 F.2d 227 (2d Cir. 1982) but see Landreth Timber Co. v. Landreth, 731 F.2d 1348 (9th Cir. 1984), cert. granted 53 U.S.L.W. 3365

(November 13, 1984, appeal argued March 26, 1985 and pending decision).

The reader must have perceived by now that the federal claims sued on here are indeed founded on the well known provisions of Rule 10b-5, 17 C.F.R. §240.10b-5.

We return to our discussion of the Agreement. Prior to the detailed warranties and representations found at ¶11, the parties (Xenon and AFP) provided a limitation of liability which reads in relevant part as follows:

> "At the closing, 10,000 shares of AFP shall be held in escrow for a period of one year from the closing date (the "Holding Period") by Lewis Siegel, Esq. ..., as Escrow Agent. In the event of Siegel's death, disability, absence or refusal or inability to act, Jeremy D. Smith, Esq. may act in his stead.
>
> If, during the Holding Period AFP shall sell the real property located ..., for a gross consideration of less than $875,000, Buyer [AFP] shall have the right to recover from said escrow that number of shares of AFP which are equal in value to the difference between the actual gross sales price received and

> $875,000 (the "Building Differential").
>
> * * *
>
> In addition, if, during the Holding Period any warranty or representation by Seller mentioned herein shall prove to be materially and substantially false and inaccurate and Buyer suffers from an actual loss in excess of $2,500 as a direct result of such inaccuracy, then Buyer shall have the right to receive from said escrow that number of AFP shares which is equal in value to the loss attributable to such inaccurate warranty or representation (the "Loss Amount").
>
> Said escrow shall be the sole source from which Buyer, its successors or assigns, shall seek or receive compensation of any nature from Seller, its shareholders, officers, directors, employees, agents, attorneys or accountants (the "Sales Group") for any claim based upon either a Building Differential or Loss Amount. The Sales Group's maximum liability for any and all losses suffered by Buyer whether attributable in whole or in part to the Building Differential or Loss Amount shall be the value of the 10,000 AFP shares held in escrow pursuant to this paragraph." (Emphasis added).

The Agreement also calls for execution of any employment contract between AFP and defendant Alexander Ross "for a period of not less than three years and

upon such terms and conditions as shall be acceptable to Mr. Ross." We are told without contradiction that a proposed employment agreement was tendered at the closing. It was not signed, nor was it rejected. Apparently the parties closed the transaction without insisting that the employment agreement issue be resolved. Under ¶14 of the contract, the obligation of the Seller (Xenon) to consummate the transactions contemplated was conditioned upon execution of the Ross employment contract. However, as far as we can see, Ross himself was never obligated in writing to sign any such contract.

Both parties, AFP and Xenon, were represented by competent attorneys. Out of their work this detailed agreement resulted. Paragraphs 21 and 22 of the Agreement provide that:

21. "This Agreement including the Exhibits, sets forth the entire understanding of the parties and supersedes any and all prior agreements, arrangements and understandings relating to the subject matter hereof. No representation, promise, inducement or statement of intention has been made by either party which is not embodied in or referred to in this Agreement, and neither party shall be bound by, nor be liable for, any alleged representation, promise, inducement or statement of intention not embodied herein. This Agreement shall be binding upon and inure to the benefit of the parties and their respective successors and assigns.

22. This Agreement cannot orally be changed or terminated. No waiver of compliance with any provisions or conditions hereof, and no consent provided for herein, shall be effective unless evidenced by an instrument in writing duly executed by the party sought to be charged with such waiver or consent. Further, waiver of any breach of any provision of this Agreement shall not constitute or operate as a waiver of any other breach of such provision, nor shall any failure to enforce any provision hereof operate as a waiver of such provision of this Agreement."

After a choice of law clause, ¶24 provides:

> 24. "All controversies arising under or in connection with, or relating to any alleged breach of this Agreement shall be settled by arbitration in New York, New York, in accordance with the rules of the American Arbitration Association then in effect and judgment under any award rendered may be entered in any court having jurisdiction."

We return to the complaint. By Paragraph 9 plaintiff alleges that the individual defendants on behalf of themselves and a purported "defendant class" of 29 shareholders made misrepresentation of specified material facts, all of which violate the warranties and representations in the written agreement of sale. Count I invokes Rule 10b-5. Assuming, as we must, that the Golden-Seagrave rule of the Second Circuit survives the grant of certiorari by the Supreme Court to review Landreth Timber, supra, nevertheless, plaintiff's Rule 10b-5 claim must fail. This is because reliance is an essential element

in a Rule 10b-5 case. In the sale of a business pursuant to a detailed agreement which contains an integration clause, a disclaimer of reliance on any other unlisted representations, preceded by an escrow agreement secured by stock deposited to indemnify within agreed limits against any false representation, no reasonable juror could find reasonable reliance on representations apart from those in the contract. To the extent absent class members, who did not deal at all with AFP, are sued, the notion of a Rule 10b-5 claim under these circumstances is even more far fetched and harassing. Accordingly, defendants are entitled to Summary Judgment even if the Golden-Seagrave rule has continuing vitality.

Count II seeks rescission, and apparently is based on state law grounds. As such a claim, it is clearly

arbitrable, and should be arbitrated. Indeed, if Count I is to be read without reference to the citation of 15 U.S.C. §78; and Rule 10b-5 contained in ¶14 of the Complaint, it too would be arbitrable. Fairly read, the arbitration clause inures to the benefit of the actual sellers, the defendant shareholders in this action, and may be invoked by them. At least for this purpose Xenon may be regarded as an agent of the selling shareholders.

Defendant's motion to compel arbitration is granted, conditioned on submission to the arbitrators of a concise statement of the disputes to be arbitrated. Nothing herein contained shall be construed to bind the arbitrators in any way with respect to any factual or legal issue submitted to them for their decision pursuant to ¶24 of the Agreement. The claim of defendant Ross

may also be arbitrated.

Settle a final judgment on five (5) days notice which shall compel such arbitration, permanently enjoin plaintiff from litigating any claims in violation of the arbitration clause and dismiss so much of the complaint which asserts a non-arbitrable claim arising under Rule 10b-5.

So Ordered.

Dated: New York, New York
May 2, 1985

/s/ CHARLES L. BRIEANT
U.S.D.J.

APPENDIX C

FINAL JUDGMENT

United States District Court,
Southern District of New York.

AFP Imaging Corporation, Plaintiff,
vs. Alexander Ross et al., Defendants,
No. 85 Civ. 1149 (CLB).

Filed: May 28, 1985.

On all papers and proceedings had herein,

NOW, THEREFORE, it is hereby:

ORDERED, ADJUDGED AND DECREED that plaintiff's motion to stay the arbitration commenced by Ross is denied in all respects; and it is further

ORDERED, ADJUDGED AND DECREED that defendant Ross' oral motion to compel arbitration of his claims against AFP is granted in all respects and Ross and AFP shall proceed to arbitration thereon; and it is further

ORDERED, ADJUDGED AND DECREED that judgment be entered in favor of defendants and against plaintiff dismissing the claim contained in Count I of the complaint with prejudice; and it is further

ORDERED, ADJUDGED AND DECREED that the parties arbitrate the claims contained in Count II of the complaint provided plaintiff submit its claims to the American Arbitration Association in New York City with a concise statement of the disputes to be arbitrated; and it is further

ORDERED, ADJUDGED AND DECREED that plaintiff AFP be, and it hereby is permanently enjoined from the commencement or continuation of any litigation in State or Federal Court against these defendants or their privies involving claims arising out of or related to the contract between AFP and Xenon

Industries, Inc. ("Xenon") dated as of August 8, 1984 pursuant to which AFP acquired all of the shares of Xenon.

Dated: New York, New York
May 28, 1985

/s/ CHARLES L. BRIEANT
U.S.D.J.

APPENDIX D

ORDER
DENYING PETITION FOR REHEARING

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the third day of February one thousand nine hundred and eighty-six.

AFP Imaging Corporation, Plaintiff-Appellant, vs. Alexander Ross, et al., Defendants-Appellees, Docket No. 85-7494.

Filed: February 3, 1986.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the Defendants-Appellees Alexander Ross, et al.

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

/s/ Elaine B. Goldsmith
Clerk

APPENDIX E

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 806, 894—August Term 1985

(Argued March 3, 1986 Decided April 16, 1986)

Docket Nos. 85-7844, 85-7846

EUGENE MCMAHON, JULIA MCMAHON, individually and as Trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

Plaintiffs-Appellants-Cross-Appellees,

—v.—

SHEARSON/AMERICAN EXPRESS, INC., and MARY ANN MCNULTY,

Defendants-Appellees-Cross-Appellants.

Before:

FEINBERG, *Chief Judge*,
and TIMBERS and NEWMAN, *Circuit Judges*.

Appeal from an order entered September 25, 1985 in the Southern District of New York, Lloyd F. MacMahon, *District Judge*, requiring broker's customers to arbitrate claims under the Securities Exchange Act of 1934 and pendent state law claims pursuant to customer agreements containing an arbitration clause, and staying litigation of an alleged RICO violation claim pending arbitration.

Affirmed in part; reversed and remanded in part.

THEODORE G. EPPENSTEIN, New York, N.Y. (Madelaine Eppenstein, and Eppenstein & Eppenstein, New York, N.Y., on the brief), *for appellants*.

THEODORE A. KREBSBACH, New York, N.Y. (Harry D. Frisch and Shearson Lehman Brothers Inc., New York, N.Y., on the brief), *for appellees*.

WILLIAM J. FITZPATRICK and GERARD J. QUINN, New York, N.Y., submitted a brief *for the Securities Industry Association, Inc., amicus curiae*.

TIMBERS, *Circuit Judge*:

Eugene McMahon and Julia A. McMahon ("appellants"), individually and as trustees for various pension and profit-sharing plans, appeal from that part of an order entered September 25, 1985 in the Southern District of New York, Lloyd F. MacMahon, *District Judge*, 618 F. Supp. 384, which required appellants to arbitrate their claims against Shearson/American Express, Inc. and its registered representative, Mary Ann McNulty, ("Shearson") for alleged violations of the Securities Exchange Act of 1934 ("1934 Act") and state law claims of fraud and breach of fiduciary duties. Shearson appeals from that part of the order holding not arbitrable appellants' claim under the Racketeer Influenced Corrupt Organizations Act, 18 U.S.C. § 1962(c) (1982) ("RICO"). The district court stayed litigation of the RICO claim pending arbitration of the securities law and state law claims.

For the reasons set forth more fully below, under the settled law of this Circuit we hold that the district court erred in holding arbitrable appellants' claims under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1982), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985). The district court, however, was correct in holding the RICO claim to be non-arbitrable. Applying the decision of the Supreme Court in *Dean Witter Reynolds, Inc.* v. *Byrd*, 105 S. Ct. 1238 (1985), we hold that arbitration of the pendent state law claims is required, even though bifurcated proceedings may result.

In short, we affirm in part, and reverse and remand in part.

I.

The facts and prior proceedings are simple and straightforward.

Appellants, individually and as trustees for various pension and profit-sharing plans, commenced this action against Shearson, a brokerage firm, and its registered representative who handled appellants' accounts. Appellants alleged that the registered representative of Shearson, with its knowledge, had violated § 10(b) of the 1934 Act and Rule 10b-5 by churning appellants' accounts, making false statements and omitting material facts from the advice given appellants. Appellants also alleged a RICO claim and state law claims for fraud and breach of fiduciary duties.

On June 15, 1982 Julia McMahon entered into a customer agreement with Shearson which contained an arbitration clause providing in relevant part as follows:

> "Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I may elect."

Relying on this clause, Shearson moved, pursuant to § 3 of the United States Arbitration Act, 9 U.S.C. § 3 (1982), to compel arbitration of all of appellants' claims. In the alternative, Shearson moved to dismiss the complaint for failure to state a claim upon which relief could be granted and on other grounds, none of which is relevant in view

of the district court's disposition of the motion to compel arbitration.

The district court rejected appellants' assertions that the customer agreement containing the arbitration clause is a contract of adhesion, that fraud is not an arbitrable issue, and that Shearson had waived its right to arbitrate. The court ordered arbitration of the § 10(b) and Rule 10b-5 claims, reasoning that recent Supreme Court decisions cast doubt on holding claims under the 1934 Act to be not arbitrable. In view of the important federal policies inherent in the enforcement of RICO by the federal courts, however, the court stayed litigation of that claim pending arbitration. The court ordered arbitration of the state law claims.

We shall examine first the district court's decision that the claims under § 10(b) and Rule 10b-5 are arbitrable. We shall then address the arbitrability of the RICO claim and state law claims.

II.

We turn first to the district court's disposition of appellants' 1934 Act claims.

We hold that the district court's decision that appellants' claims under § 10(b) and Rule 10b-5 are arbitrable is an unwarranted departure from the settled law of this Circuit and must be reversed.

In *Wilko* v. *Swan*, 346 U.S. 427 (1953), the Supreme Court held that, despite the United States Arbitration Act, 9 U.S.C. § 1 *et seq.*, claims arising under § 12(2) of the Securities Act of 1933 ("1933 Act") are not arbitrable. In reaching this result, the Court pointed out that an agreement to arbitrate claims is void under § 14 of the

1933 Act as a stipulation binding the securities customer to waive compliance with a provision of the Act.[1] The provision referred to is the aggrieved party's right to select the judicial forum under § 22(a) of the 1933 Act.

As our late colleague, Judge Friendly, noted in *Colonial Realty* v. *Bache & Co.*, 358 F.2d 178, 183 n.5 (2 Cir.), *cert. denied*, 385 U.S. 817 (1966), the non-waiver provision of § 14 of the 1933 Act has an almost identical counterpart in § 29(a) of the 1934 Act.[2] In view of *Wilko* and the similarity of the non-waiver provisions of the 1933 and 1934 Acts, we consistently have held that § 10(b) and Rule 10b-5 claims are not arbitrable.[3] In *Greater Continental Corp.* v. *Schechter*, 422 F.2d 1100, 1103 (2 Cir. 1970), we observed that alleged violations of Rule 10b-5 were "properly litigated in the courts where a

---

1. Section 14 of the Securities Act of 1933, 15 U.S.C. § 77n (1982), provides:

> "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

2. Section 29(a) of the Securities Act of 1934, 15 U.S.C. § 78cc(a) (1982), provides:

> "Any condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

3. Following *Wilko*, several other courts of appeals likewise have held that claims arising under the 1934 Act are not arbitrable. *E.g.*, *De Lancie* v. *Birr, Wilson & Co.*, 648 F.2d 1255, 1258-59 (9 Cir. 1981); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1039 (6 Cir. 1979); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Moore*, 590 F.2d 823, 827-29 (10 Cir. 1978); *Weissbuch* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 833-35 (7 Cir. 1977); *Sibley* v. *Tandy Corp.*, 543 F.2d 540, 543 (5 Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Ayres* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 (3 Cir.), *cert. denied*, 429 U.S. 1010 (1976).

complete record is kept of the proceedings and findings and conclusions are made." We also pointed out the similarity between § 14 of the 1933 Act and § 29(a) of the 1934 Act. *Id.* In *Allegaert* v. *Perot*, 548 F.2d 432, 436-38 (2 Cir.), *cert. denied*, 432 U.S. 910 (1977), we reiterated the view that claims under § 10(b) of the 1934 Act are not arbitrable, noting that the broad policy questions involved in securities law claims require a judicial forum for resolution of disputes. Again in *AFP Imaging Corp.* v. *Ross*, 780 F.2d 202, 205 (2 Cir. 1985), we held that, in an action which alleged violations of § 10(b) and Rule 10b-5, an arbitration clause in the contract was "unenforceable under the law of this Circuit".

Despite the settled law of this Circuit that claims under § 10(b) and Rule 10b-5 of the 1934 Act are not arbitrable, Shearson, speculating as to what the Supreme Court may do with our settled law, invites us to overrule our own precedents. We decline the invitation.

The district court, in addition to emphasizing the strong national policy favoring arbitration, focused on the Supreme Court's decisions in *Dean Witter Reynolds, Inc.* v. *Byrd*, 105 S. Ct. 1238 (1985), and *Scherk* v. *Alberto-Culver Co.*, 417 U.S. 506 (1974). In *Byrd*, since the securities broker had sought to compel arbitration of only pendent state claims—not claims arising under the 1934 Act—the Court declined to reach the issue of whether § 10(b) and Rule 10b-5 claims are arbitrable. 105 S. Ct. at 1240 n.1. Nevertheless, various courts, in holding that § 10(b) and Rule 10b-5 claims are arbitrable, have sought refuge in Justice White's concurring opinion in *Byrd*, 105 S. Ct. at 1244. Justice White stated that *Wilko's* reasoning cannot be "mechanically transplanted" to the 1934 Act. *Id.* While acknowledging the similarity

between § 14 of the 1933 Act and § 29(a) of the 1934 Act, Justice White reasoned that the narrower jurisdiction under the 1934 Act and the implied, rather than express, causes of action under § 10(b) and Rule 10b-5 distinguished claims under the 1934 Act from those arising under the 1933 Act. *Id.* Both the *Byrd* majority and Justice White's concurring opinion acknowledged that *Scherk* v. *Alberto-Culver Co.*, *supra*, 417 U.S. at 513-15, cast some doubt on the applicability of *Wilko* to claims under § 10(b) or Rule 10b-5. 105 S. Ct. at 1240 n.1; 105 S. Ct. at 1244.[4] The Supreme Court in *Byrd*, however, referred to the *Scherk* decision as follows:

> "The [*Scherk*] Court did not, however, hold that *Wilko* would not apply in the context of a § 10(b) or Rule 10b-5 claim, and *Wilko* has retained considerable vitality in the lower federal courts. Indeed, numerous District Courts and Courts of Appeals have held that the *Wilko* analysis applies to claims arising under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and that agreements to arbitrate such claims are therefore unenforceable."

105 S. Ct. at 1240 n.1. (Citations omitted, being among those included in note 3, *supra*).

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4. Indeed, some courts within this Circuit have interpreted dicta in *Scherk* and *Byrd* as authority for holding such claims to be arbitrable. *E.g.*, *Intre Sport Ltd.* v. *Kidder, Peabody & Co.*, 625 F. Supp. 1303 (S.D.N.Y. 1985); *Finkle & Ross* v. *A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505 (S.D.N.Y. 1985); *Jarvis* v. *Dean Witter Reynolds, Inc.*, 614 F. Supp. 1146 (D. Vt. 1985); *Brener* v. *Becker Paribas, Inc.*, 84 Civ. 5872 (S.D.N.Y. Dec. 31, 1985); *Ilan* v. *Shearson/American Express, Inc.*, 83 Civ. 9319 (S.D.N.Y. Dec. 23, 1985); *Johnson* v. *Kidder, Peabody & Co.*, 85 Civ. 178 (N.D.N.Y. July 30, 1985).

Other courts have continued to follow the settled law of this Circuit, holding claims under § 10(b) and Rule 10b-5 not arbitrable. *E.g.*, *Leone* v. *Advest, Inc.*, 624 F. Supp. 297 (S.D.N.Y. 1985); *Weizman* v. *Adornato*, 84 Civ. 3603 (E.D.N.Y. April 25, 1985).

In the instant case, the district court focused on the allegations of churning and misrepresentation centered on particular securities accounts and held inapplicable the broad policy concerns which this Circuit has recognized in holding 1934 Act claims not arbitrable. While a churning claim by its nature is limited to the specific accounts in question, such claims also reflect the public interest and are important in their deterrent effect. The securities laws generally, and the implied causes of action which the courts have recognized, are designed to protect the public, and particularly the less sophisticated investor. Moreover, this Circuit has not recognized an exception to the non-arbitrability of securities law claims in circumstances other than disputes between member firms of the stock exchanges. *E.g.*, *Coenen* v. *R. W. Pressprich & Co.*, 453 F.2d 1209 (2 Cir.), *cert. denied*, 406 U.S. 949 (1972); *Axelrod & Co.* v. *Kordich, Victor & Neufeld*, 451 F.2d 838 (2 Cir. 1971). We see no justification for carving out an exception to our non-arbitrability precedents for individual claims of churning and misrepresentation.

In short, the similarity of the non-waiver provisions, § 14 of the 1933 Act and § 29(a) of the 1934 Act, as well as the strong public policy concerns inherent in the securities laws and the legislative history that preceded their enactment, support the compelling need for a judicial forum in the resolution of securities law disputes. Although *Scherk* and *Byrd* may cast some doubt on whether the Supreme Court, if presented with the issue, would hold claims under § 10(b) and Rule 10b-5 to be non-arbitrable, it would be improvident for us to disregard clear judicial precedent in this Circuit based on mere speculation. We think that the orderly administration of justice will be best served if we as one of the inferior

courts follow Supreme Court precedent and adhere to the settled law of this Circuit, and a fortiori the district courts should do likewise.

III.

We turn next to the district court's disposition of appellants' RICO claim.

Pointing to the important federal policies inherent in the enforcement of RICO by the federal courts, the district court stayed litigation of the RICO claim pending arbitration of the state law claims and the securities law claims. The RICO claim was thus placed on the suspense docket pending the outcome of arbitration of the other claims.

In other contexts, we have recognized the inappropriateness of the United States Arbitration Act when strong public policy considerations are involved. In *American Safety Equipment* v. *J.P. Maguire* 391 F.2d 821 (2 Cir. 1968), we stated that "[a] claim under the antitrust laws is not merely a private matter. The Sherman Act is designed to promote the national interest in a competitive economy; thus, the plaintiff asserting his rights under the Act has been likened to a private attorney-general who protects the public's interest." 391 F.2d at 826. We hold that there are comparable concerns inherent in the enforcement of RICO claims.

The Supreme Court has recognized that arbitration is appropriate in *international* antitrust disputes because of concerns for international comity, respect for the capacities of foreign and transnational tribunals, and the need for predictability in the international commercial system. *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth,*

Inc., 105 S. Ct. 3346 (1985). The reasoning of our decision in *American Safety*, however was not disputed in *Mitsubishi*, "as applied to agreements to arbitrate arising from domestic transactions." 105 S. Ct. at 3355. Enforcement of the RICO statute is particularly appropriate in a judicial forum because of strong policy concerns, the need for development of the record, and judicial clarification and resulting consistency in resolving disputes under this relatively new statute.

The district court had placed the RICO claim on the suspense docket because the arbitrable claims "permeate the case, and the validity of the RICO claim is uncertain at this stage of the litigation." 618 F. Supp. at 389. Since we have held that the securities law claims are not arbitrable, it is now appropriate that the securities law and RICO claims be litigated together since they arise out of the same transaction.[5]

IV.

Finally, this brings us to the district court's disposition of appellants' pendent state law claims.

In addition to the claims that Shearson had violated § 10(b), Rule 10b-5, and RICO, appellants' amended complaint alleged state law claims for common law fraud and breach of fiduciary duties. The district court granted Shearson's motion to compel arbitration of these pendent state law claims as well as the securities law claims.

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5. Appellants suggest that the district court's denial of arbitration of the RICO claim was not an appealable interlocutory order under 28 U.S.C. § 1292(a) (1982). We disagree. *See Ettelson* v. *Metropolitan Life Insurance Co.*, 317 U.S. 188, 191 (1942); *Enelow* v. *New York Life Insurance Co.*, 293 U.S. 379, 383 (1935); *Poriss* v. *Aacon Auto Transport, Inc.*, 685 F.2d 56, 59-60 (2 Cir. 1982).

Under the Supreme Court's decision in *Dean Witter Reynolds, Inc.* v. *Byrd, supra*, these state law claims must be sent to arbitration where there is an enforceable arbitration clause and where a party's motion to compel arbitration encompasses the state law claims, as here.[6] *See also AFP Imaging Corp.* v. *Ross, supra*, 780 F.2d at 205. The Court's language in *Byrd* is unequivocal.

> "[T]he Arbitration Act requires district courts to compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums."

105 S. Ct. at 1241. The Court also recognized that such bifurcated proceedings could result where securities or antitrust violations are alleged. 105 S. Ct. at 1241 n.5. We hold that the district court correctly held that the pendent state claims were arbitrable. Despite the potential inefficiency of bifurcated proceedings, we are obliged under *Byrd* to affirm that part of the district court's order compelling arbitration of the pendent state law claims.[7]

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6. Appellants challenge the arbitrability of their claims against Shearson on numerous grounds. In view of our rulings on the securities and RICO claims, these arguments are not relevant to the litigation of the disputes under federal law but they do require brief examination since, generally, state law claims for fraud and breach of fiduciary duties are arbitrable if there is a valid arbitration clause. In the instant case, the district court found that the elements for compelling arbitration were present, *i.e.*, an agreement to arbitrate, arbitrable claims, and the absence of a waiver. We find no reason to disturb the district court's threshold determination that an enforceable arbitration clause was in effect. While we hold the federal claims here are not within the scope of the arbitration clause, we also hold that the court correctly compelled arbitration of the state law claims for fraud and breach of fiduciary duties.

7. Of course, if appellants, upon remand of this case to the district court, should withdraw their pendent state law claims, that would

V.

To summarize:

We hold that the district court erred in departing from this Circuit's precedents in granting Shearson's motion to compel arbitration of the claims alleging a violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The district court properly denied the motion to compel arbitration of the RICO claim because of the inherent public interest underlying that cause of action and the need for examining and resolving such disputes in the federal courts. The district court properly compelled arbitration of the pendent state law claims.[8]

Affirmed in part; reversed and remanded in part.

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result in no claims left to be arbitrated. All remaining claims would be litigated in the federal court. And bifurcated proceedings would be avoided. *See AFP Imaging Corp.* v. *Ross*, *supra*, 780 F.2d at 205.

8. Though the applicability of *Wilko* v. *Swan*, *supra*, to issues arising under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 is settled in this Circuit, it would nonetheless have been helpful if the Securities and Exchange Commission had volunteered an amicus brief to inform us of its views. Without any request, the Commission rendered substantial help with respect to corresponding questions under the Securities Act of 1933 in *Wilko* v. *Swan*, *supra*—both in this Court, 201 F.2d at 440, 441-42, 445, and in the Supreme Court, 346 U.S. at 427, 428, 440.

APPENDIX F

UNITED STATES ARBITRATION ACT
9 U.S.C. §1 et seq.

§2. Validity, irrevocability, and enforcement of agreements to arbitrate

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

§3. Stay of proceedings where issue therein referable to arbitration

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

APPENDIX G

SECURITIES & EXCHANGE ACT OF 1934
15 U.S.C. §78

§78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --

. . . . .

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§78aa. Jurisdiction of offenses and suits

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdictions of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the

defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, and 1292 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

§78cc. Validity of contracts

(a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

No. 85-1805

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

October Term, 1985

ALEXANDER ROSS, JAMES L. MELCHER, IVAN BLOCH, VINCENT GIOVINCO, BRUCE MALE, FREDERICK M. MYERS, JOHN C. FITCH, and LEWIS W. SIEGAL, individually and as representative of all others similarly situated,

Petitioners,

vs.

AFP IMAGING CORPORATION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF IN OPPOSITION

STUART A. SUMMIT
445 Park Avenue
New York, New York 10022
(212) 702-2271

Attorney for Respondent

Of Counsel:

SUMMIT ROVINS & FELDESMAN
WILLIAM A. ALPER
GERARD A. RISO

32pp

Counterstatement of the Question Presented

Given that the non-arbitrability of claims alleging violations of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et. seq.*, has been long-established federal policy, and given that section 27 of the Act provides for exclusive jurisdiction in the federal courts of claims under the Act and that section 29(a) of the Act voids any contract, stipulation or provision waiving any provision of the Act, may a purchaser of securities be compelled to arbitrate a section 10(b) securities fraud claim against his sellers pursuant to a pre-dispute arbitration clause in the allegedly fraudulent contract for the sale of securities?

List of all Parties

See Memorandum For The Petitioners at ii. The list of respondent's affiliated corporations is as follows: AFP/Matrix Imaging (UK) Ltd.; AFP/Kenro; CES Imaging Products, Inc.; Instrumentation Camera Inc.; Pako Corporation; Tudorcape Inc.; Kenro Corporation; and Photo Guard Associates.

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No. 85-1805

IN THE

Supreme Court of the United States

October Term, 1985

ALEXANDER ROSS, JAMES L. MELCHER, IVAN BLOCH, VINCENT GIOVINCO, BRUCE MALE, FREDERICK M. MYERS, JOHN C. FITCH, and LEWIS W. SIEGAL, individually and as representative of all others similarly situated,

Petitioners,

vs.

AFP IMAGING CORPORATION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF IN OPPOSITION

Opinions Below

See Memorandum For The Petitioners at 1, and A-1 to A-24.

Jurisdiction

See Memorandum For The Petitioners at 2.

Statutes Involved

See Memorandum For The Petitioners at 2-3, and A-38 to A-42, and the appendix hereto at A-1—A-2.

Counterstatement of the Case

Petitioners sold all of the capital stock of Xenon Industries, Inc. to respondent, AFP Imaging Corporation. The written contract of sale, dated August 8, 1984, was nominally between Xenon and AFP; however, Xenon acted as petitioners' agent, pursuant to express written authority, to "cause the sale" of petitioners' stock to AFP.

In order to induce AFP to acquire their Xenon shares, petitioners made several false representations to AFP in the contract of sale concerning Xenon's financial condition. Petitioners represented, *inter alia,* that Xenon's financial statements were accurate. After the closing of the sale, AFP learned that those representations were false, and by reason of petitioners' fraud has suffered losses of at least $900,000. AFP commenced an action in the United States District Court for the Southern District of New York alleging that petitioners' knowing misrepresentation of Xenon's financial condition was a violation of section 10(b) of the Securities Exchange Act of 1934[1] and Rule 10b-5 of

1. The Securities Exchange Act of 1934 will be referred to as the 1934 Act. The Securities Act of 1933 will be referred to as the 1933 Act. References to sections 10(b); 27; and 29(a) of the 1934 Act are references to, respectively: 15 U.S.C. § 78j(b) (section 10(b)); 15 U.S.C. § 78aa (section 27); 15 U.S.C. § 78cc(a) (section 29(a)). References to sections 12; 14; and 22 of the 1933 Act are references to, respectively: 15 U.S.C. § 771 (section 12); 15 U.S.C. § 77n (section 14); 15 U.S.C. § 77v (section 22). Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5, is referred to as Rule 10b-5. The text of these provisions of the 1934 Act and the provisions of the United States Arbitration Act, 9 U.S.C. §§ 2 and 3, are set forth in the appendix of Memorandum for Petitioners at A-38 to A-42. Relevant provisions of the 1933 Act are set forth in the appendix attached hereto at A-1 to A-2.

the Securities and Exchange Commission and that those misrepresentations constituted common law fraud.

After the action was commenced, petitioners attempted to preclude respondent's efforts to obtain judicial relief by moving to compel arbitration of AFP's claims pursuant to an arbitration clause in the contract of sale. Petitioners also moved to dismiss the action pursuant to Rule 9(b) of the Federal Rules of Civil Procedure and subsequently converted their motion to dismiss to a motion for summary judgment.

On May 2, 1985, the District Court (Brieant, J.) granted petitioners summary judgment as to AFP's section 10(b) securities fraud claim and granted petitioners' motion to compel arbitration of AFP's state law claim. It did not reach the question of the arbitrability of AFP's section 10(b) claim.

AFP appealed to the United States Court of Appeals for the Second Circuit. On Appeal, petitioners attempted to defend the District Court's grant of summary judgment. Consequently, in the Second Circuit neither party briefed or argued the question petitioners present here concerning the arbitrability of a section 10(b) claim.

On December 23, 1985, the Second Circuit reversed the summary judgment dismissing AFP's section 10(b) claim. *AFP Imaging Corp.* v. *Ross,* 780 F.2d 202 (2d Cir. 1985).

The Second Circuit, after reversing summary judgment, remanded the securities fraud claim to the District Court. In remanding this claim it stated that, pursuant to the long standing rule in the Second Circuit, the arbitration pro-

vision in the contract of sale was "of course, unenforceable." *Id.* at 205. Petitioners sought to raise the question of the arbitrability of the section 10(b) claim for the first time in the Second Circuit in their petition for rehearing and suggestion for rehearing *en banc*. The Second Circuit denied the petition on February 3, 1986.[2] Petitioners now seek *certiorari* to have this Court review the long-standing federal policy that section 10(b) claims are not arbitrable, an issue the District Court did not decide, which petitioners did not argue or brief in the Second Circuit, and which they raised for the first time in that Court in their petition for rehearing.[3]

Certiorari Should Be Denied

The unenforceability of a pre-dispute arbitration agreement with respect to claims under section 10(b) of the 1934 Act has been the long established rule in every circuit which has considered the question. (See cases cited *infra* at 9, n.4). The rule is soundly grounded in federal policy and in *Wilko* v. *Swan*, 346 U.S. 427 (1953), in which this Court held that claims under section 12(2) of the 1933 Act are not arbitrable. In *Dean Witter Reynolds, Inc.* v. *Byrd*, —— U.S. ——, 105 S.Ct. 1238, 1240, n.1 (1985), this Court recently noted in *dictum* that it had previously questioned the application of *Wilko* by the lower federal courts to 1934 Act claims, but also that the applicability of *Wilko* to such

2. AFP represented to the Court of Appeals that it would withdraw its common law fraud claim on remand, mooting the issue of the arbitrability of that claim. *AFP Imaging Corp.* v. *Ross, supra* at 205. The claim was subsequently withdrawn. *AFP Imaging Corp.* v. *Ross*, No. 85 Civ. 1149-CLB (S.D.N.Y. 1986).

3. Respondent was served with the present Petition on May 2, 1986.

claims "has retained considerable vitality in the lower federal courts." *Id.* In this case, commenced before *Byrd* and arising out of a transaction which had taken place long before *Byrd*, the Second Circuit restated the long-standing rule that pre-dispute agreements to arbitrate section 10(b) claims are "of course, unenforceable." *AFP Imaging Corp.* v. *Ross, supra* at 205. Even more recently, in *McMahon* v. *Shearson/American Express, Inc.*, Dkt. Nos. 85/7844, 85/7846 slip op. (2d Cir. April 16, 1986) the Second Circuit reiterated the rule.

The Court should deny *certiorari* because:

1. This case is not an appropriate vehicle for review of the long-established federal policy that section 10(b) claims are not arbitrable.

2. There is no conflict in the circuits as to the long-standing federal policy that section 10(b) claims are not arbitrable;

3. The Second Circuit rule is not in conflict with any decision of this Court; and

4. The decision below is correct.

A. This Is Not An Appropriate Vehicle For This Court to Review The Established Federal Policy Of The Nonarbitrability Of Section 10(b) Claims

1. The District Court Did Not Decide The Question Presented And Petitioners Did Not Raise It In the Second Circuit

The issue presented by the petitioners was neither briefed nor argued in the Second Circuit. The District Court had granted summary judgment dismissing AFP's federal securities fraud claim without deciding their motion to compel arbitration of that claim.

On appeal, AFP sought review of the District Court's grant of summary judgment (and other orders not pertinent here). Petitioners chose not to argue, as an additional ground justifying the District Court's dismissal of AFP's section 10(b) claim, that it was arbitrable, even though this Court had already questioned in *Byrd* whether the long-standing federal policy against enforcing agreements to arbitrate section 10(b) claims should be re-examined. Petitioners confined their arguments on appeal to defending the District Court's grant of summary judgment.

It was only after the Second Circuit stated, in reversing summary judgment and remanding the section 10(b) claim to the District Court, that the arbitration clause was "of course, unenforceable," *AFP Imaging Corp.* v. *Xenon, supra* at 205, that petitioners sought to argue this issue in their petition for rehearing. The Second Circuit properly denied petitioners' petition for rehearing as to a claim they could have, but did not, present and argue in the first instance. *See Donovan* v. *Brandel,* 760 F.2d 126 (6th Cir. 1985);

United States v. *Klotz*, 503 F.2d 1056 (8th Cir. 1974); *Local No. 1505 Int'l Bro. of Elec. Workers* v. *Local Lodge No. 1836*, 304 F.2d 365, 368 (1st Cir. 1962); *Carr* v. *Federal Trade Comm'n*, 302 F.2d 688, 692 (1st Cir. 1962).

It would certainly be anomalous for petitioners to obtain review on *certiorari* of an issue they sought to present to the Court of Appeals only as an afterthought in a petition for rehearing which the Court of Appeals denied.

Further, because the parties did not have an opportunity to brief and develop this issue in the Second Circuit, this Court would have to determine the enforceability of pre-dispute agreements to arbitrate section 10(b) claims without the benefit of development and amplification of the arguments, or a reasoned opinion, in the court below. *See Kimbrough* v. *United States*, 364 U.S. 661 (1961) (writ of certiorari dismissed because the record did not present the question with sufficient clarity). After this Court commented on the applicability of *Wilko* to section 10(b) claims in *Byrd*, numerous district courts re-examined the issue. A future case in which the issue is fully developed on the record, argued and decided in a circuit court, would benefit this Court with a variety of views and a full development of the issues and arguments presented should this Court later desire to decide this question.

2. The Record Does Not Present Or Develop The Question Presented With Sufficient Clarity

The contract of sale, dated August 8, 1984, was entered into and the sale of stock completed before this Court decided *Dean Witter Reynolds, Inc.* v. *Byrd*, *supra*. Prior to

Byrd, the law was clear in the Second Circuit, *e.g.*, *Greater Continental Corp.* v *.Schechter*, 402 F.2d 1100 (2d Cir. 1970), and in at least eight other circuits (see cases cited, *infra* at 9, n.4), that section 10(b) claims were not arbitrable. Indeed, even in *Byrd*, Dean Witter Reynolds, Inc. did not seek to compel arbitration of the section 10(b) claim asserted against it because it assumed that the arbitration clause in its contract was unenforceable as to a section 10(b) claim. *Dean Witter Reynolds, Inc.* v. *Byrd, supra*, at 1240, n.1.

Thus, at the time of the contract at issue and at the commencement of this action, AFP had relied on the established rule that federal securities fraud claims were not arbitrable. The arbitration clause in its contract of sale with petitioners was designed to redress the type of disputes that may arise from a good faith transaction—not an integrated scheme to defraud purchasers to buy grossly overvalued stock. Because of the settled status of the law at the time this action was commenced, AFP did not allege in its complaint that the arbitration clause was unenforceable and was part of petitioners' scheme to defraud by precluding respondent from exercising its right under section 27 of the 1934 Act to seek redress in a federal court. *See The Bremen* v. *Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972). In these circumstances, the issue of the arbitrability of section 10(b) claims is not presented to this Court with the factual development in the lower courts which a post-*Byrd* transaction might afford.

Further, this action was commenced, and summary judgment granted, before this Court decided *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, —— U.S. ——, 105

S.Ct. 3346 (1985). Thus, there was certainly no opportunity in this litigation for the parties or the lower courts to examine and develop evidence relevant to the factors which need to be considered in deciding arbitrability of a claim pursuant to this Court's decision in *Mitsubishi*. Therefore, this case is not an appropriate vehicle to review the established federal policy precluding arbitration of section 10(b) claims.

B. There Is No Conflict In the Circuits As to the Federal Policy That Section 10(b) Claims Are Not Arbitrable

Petitioners have stated that the Second Circuit's decision in this case "is in direct conflict with holdings of other courts...." (Memorandum For The Petitioners at 19. See also pp. 8, 17-19). The "other courts" petitioners refer to are district courts, and many of those courts were district courts within the Second Circuit. Presumably, those courts will henceforth abide by the Court of Appeals' direction to "adhere to the settled law of this Circuit." *McMahon*, *supra*, slip op. at 2756.

Rule 17(a) of this Court provides that a writ of certiorari may be granted "[w]hen a federal court of appeals has rendered a decision in conflict with the decision of another federal court of appeals on the same matter." The decision of the Court of Appeals in this case is not in conflict with a decision of the Court of Appeals of any other circuit and, as this Court has recognized, the Second Circuit's rule has retained "considerable vitality" in the other Courts of Appeals.[4] *Dean Witter Reynolds, Inc* v. *Byrd*, —— U.S. at ——, 105 S.Ct. at 1240, n.1 (1985).

4. At least nine circuit courts, the Second, Third, Fifth, Sixth Seventh, Eight, Ninth, Tenth, and Eleventh Circuits, have held that

(footnote continued on next page)

Since *Dean Witter Reynolds, Inc.* v. *Byrd, supra,* the decisions of various district courts may be in conflict with their circuits' precedents or with other district courts. *Compare, Moncrieff* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 623 F. Supp. 1005 (E.D. Mich. 1985) (rejecting prior Sixth Circuit precedent that section 10(b) claims are not arbitrable) *with Bale* v. *Dean Witter Reynolds Inc.*, No. 85-1280, slip op. (D. Minn. Jan. 30, 1986) (following Eighth Circuit precedent that section 10(b) claims are not arbitrable). However, no conflict exists among the circuit courts as to the unenforceability of an arbitration clause as to a section 10(b) claim.[5] If a conflict should subse-

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Wilko applies to section 10(b) claims. *E.g., Greater Continental Corp.* v. *Schechter*, 422 F.2d 1100, 1103 (2d Cir. 1970); *Ayres* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 (3rd Cir.), *cert. denied*, 429 U.S. 1010 (1976); *Sibley* v. *Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1039 (6th Cir. 1979); *Weissbuck* v. *Merrill Lynch, Pierce, Fenner & Smith*, 558 F.2d 831, 833-835 (7th Cir. 1977); *Surman* v. *Merrill Lynch, Pierce Fenner & Smith, Inc.*, 733 F.2d 59 (8th Cir. 1984); *DeLancie* v. *Birr, Wilson & Co.*, 648 F.2d 1255, 1258-59 (9th Cir. 1981); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Moore*, 590 F.2d 823, 827-29 (10 th Cir. 1978); *Raiford* v. *Buslease, Inc.*, 745 F.2d 1419 (11th Cir. 1984). The Fourth, First and D.C. Circuits appear not to have ruled specifically on this question. *Land* v. *Dean Witter Reynolds, Inc.*, 617 F.Supp. 52 (E.D. Va. 1985); *see Singer* v. *Dean Witter Reynolds, Inc.*, 614 F.Supp 1141 (D. Mass. 1985); *cf. Ingbar* v. *Drexel Burnham Lambert, Inc.*, 683 F.2d 603, n.1 (1st Cir. 1982) (recognizing that *Wilko* has been extended by caselaw to 1934 Act claims). The Second Circuit is the only circuit to date that has reaffirmed its prior holding since *Dean Witter Reynolds, Inc.* v. *Byrd, supra. See McMahon* v. *Shearson/American Express, Inc.*, Dkt. Nos. 85-7844, 85-7846 (2d Cir. April 16, 1986); *AFP Imaging Corp.* v. *Ross*, 780 F.2d 202 (2d Cir. 1985). In *Shihadeh* v. *Dean Witter Reynolds, Inc.*, 766 F.2d 461 (11th Cir. 1985), the Eleventh Circuit remanded the order staying arbitration of claims under the 1934 Act for reconsideration by the district court in light of *Dean Witter Reynolds, Inc.* v. *Byrd, supra,* and prior Eleventh Circuit precedent in *Raiford* v. *Buslease, supra.*

5. Petitioners have stated that arguments have been held in cases that are *sub judice* in the Third and Ninth Circuits. (Memorandum For The Petitioners at 18, n.6).

quently materialize between the Second Circuit and another circuit, the issue will then be ripe for review should this Court decide to determine it. This Court would then have the benefit of the divergent views of the various courts of appeals after careful scrutiny of the issue on full records. This case does not present such an opportunity.

C. The Opinion Below Is Not In Conflict With Any Decision of This Court

The opinion below is not in conflict with any decision of this Court. Contrary to petitioners' contention, it is wholly consistent with, and based upon, *Wilko* v. *Swan, supra; Dean Witter Reynolds, Inc.* v. *Byrd, supra; Scherk* v. *Alberto-Culver Co.*, 417 U.S. 506 (1974); and *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, —— U.S. ——, 105 S.Ct. 3346 (1985).

In *Wilko* v. *Swan, supra*, this Court held that an arbitration clause in a pre-dispute contract was not enforceable as to a claim under section 12(2) of the 1933 Act. This Court found that such an agreement was a "stipulation" binding the plaintiff to "waive compliance" with a "provision" of the 1933 Act, section 22(a), in contravention of section 14 of the Act. Section 22(a) of the 1933 Act provides the claimant a right to select a judicial forum, with all of the attendant rights. Section 14 voids an agreement waiving that right. The Court held that the provisions of the United States Arbitration Act, 9 U.S..C § 1 *et seq.*, were not controlling in view of the non-waiver provisions of section 14. *Id.* Like the 1933 Act, the 1934 Act provides the right to a judicial forum, section 27, and contains a non-waiver provision, section 29(a), nearly identical to section 14 of the 1933 Act.

Numerous lower courts have similarly interpreted the provisions of the 1934 Act and have extended the reasoning of *Wilko* to 1934 Act claims. In *Scherk* v. *Alberto-Culver Co.*, 417 U.S. 506 (1974), this Court noted that a colorable argument could be made that *Wilko* does not apply to section 10(b) claims because, unlike section 12 of the 1933 Act, in which a private right of action is expressly granted, the right of action under section 10(b) is implied. *Scherk* also noted another distinction between the 1934 and 1933 Acts: section 22 of the 1933 Act provides for state or federal jurisdiction while section 27 of the 1934 Act provides for exclusive federal jurisdiction. *Scherk* v. *Alberto-Culver Co., supra,* at 513.[6]

However, in *Scherk,* this Court accepted "the premise . . . that the operative portions of the language of the 1933 Act relied upon in *Wilko* are contained in the Securities Exchange Act of 1934." *Id.* at 515. The arbitration clause in that case was enforced as to a section 10(b) claim only because the transaction involved an international agreement. This Court found that in the context of international agreements "[a] contractual provision specifying in advance the forum in which disputes shall be litigated. . . is . . . an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction." *Id.* at 516. This Court reasoned that unless the arbitration clause in an international contract were enforceable it would "damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international commercial agreements." *Id.* at 517. The instant case involves a

6. These distinctions between the 1934 Act and the 1933 Act should not limit the applicability of *Wilko* to section 10(b) claims. (See *infra* at 14-17.)

wholly domestic transaction and none of those special considerations of international trade and comity are present here.

In *Byrd,* this Court noted that it had questioned the applicability of *Wilko* to section 10(b) claims in *Scherk* but did not hold that *Wilko* did not apply. *Byrd* rejected the "intertwining doctrine," a rule adopted in many of the lower federal courts, which had precluded arbitration of pendent state law claims which were "intertwined" with non-arbitrable federal securities law claims. In rejecting the intertwining doctrine, this Court expressly declined to rule on whether *Wilko* applied to section 10(b) and Rule 10b-5 claims, but commented in a footnote that:

> In *Wilko* v. *Swan,* 346 U.S. 427 (1963), this Court held that a predispute agreement to arbitrate claims that arise under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2), was not enforceable. . . . Years later, in *Scherk* v. *Alberto-Culver Co.,* 417 U.S. 506 (1974), this Court questioned the applicability of *Wilko* to a claim arising under § 10(b) . . . or Rule 10b-5. . . . The Court did not, however, hold that *Wilko* would not apply in the context of a § 10(b) or Rule 10b-5 claim, and *Wilko* has retained considerable vitality in the lower federal courts. Indeed, numerous District Courts and Courts of Appeals have held that the *Wilko* analysis applied to claims arising under § 10(b) . . . and that agreements to arbitrate such claims are therefore unenforceable.

Id. at ——, n.1, 105 S.Ct. at 1240, n.1.

Thus, *Byrd* expressly recognized the law prevailing in the lower federal courts and did nothing to alter it.[7]

7. The Second Circuit was aware of *Dean Witter Reynolds, Inc.* v. *Byrd* when it decided this case and noted that this Court considered the question open. *AFP Imaging Corp.* v. *Ross,* 780 F.2d *supra* at 205.

Finally, the opinion below is not in conflict with this Court's recent pronouncements concerning the United States Arbitration Act in *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, —— U.S. ——, 105 S.Ct. 3346 (1985). *Mitsubishi*, like *Scherk*, concerned an international agreement. Moreover, *Mitsubishi* involved an agreement to arbitrate a claim under the Sherman Act, 15 U.S.C. § 1, *et seq.*, not the 1934 Act. The Sherman Act, unlike the 1933 and 1934 Acts, does not contain a "nonwaiver" provision which, *Wilko* held, could not be disregarded by a court in favor of a pre-dispute agreement to arbitrate.

D. The Decision Below Is Correct

Petitioners contend that *Wilko* should not apply to 1934 Act claims because of certain distinctions between the 1933 and 1934 Acts: (1) section 12(2) of the 1933 Act provides an express right of action while the right of action under section 10(b) is implied; and (2) jurisdiction under section 22 of the 1933 Act extends to any state or federal court while jurisdiction of suits under the 1934 Act is limited by section 27 to the federal courts. (Memorandum for the Petitioners at 10-14). Petitioners also contend that *Wilko* should not apply to an arbitration clause negotiated between the parties in an arm's-length agreement. None of their arguments warrant reversal of long standing federal policy adhered to in at least nine federal circuits.

1. The Distinction Between Implied and Express Rights of Action Should Not Limit the Applicability of *Wilko* v. *Swan*

Wilko did not hold that a pre-dispute agreement to arbitrate 1933 Act claims was unenforceable because section 12(2) of 1933 Act created an express right of action.

Rather, the arbitration agreement was held unenforceable because it waived the right to sue in a federal or state court which was guaranteed to an investor by section 22. *Wilko* v. *Swan, supra* at 436. It was the statutory right of a purchaser to judicial trial and review of a claim under the 1933 Act, *i.e.*, section 22, that this Court held could not be waived.

Applying the rationale of *Wilko* to the 1934 Act, it is not the implied right of action under section 10(b) that is impermissibly waived by a pre-dispute agreement to arbitrate, but the right, expressly granted by section 27, to trial of 1934 Act claims in a district court and to appellate review. Section 27 of the 1934 Act expressly applies to any action in equity or at law to enforce a duty under the 1934 Act. An action under section 10(b) is clearly one to enforce a duty under the 1934 Act since it has no other source but the 1934 Act. It is of no moment that the right of action is implied for it exists just as if it were expressly provided, and its existence is "simply beyond preadventure." *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 (1986). Thus, by its terms, section 27 applies to an action under section 10(b).

A right of action is implied only when it is found that Congress intended to create such an action. *Touche Ross* v. *Redington*, 442 U.S. 560 (1979). The right to sue to enforce the duties created by section 10(b) of the 1934 Act is no less part of statute for being implied than its express provisions—it exists solely because Congress intended it. The "question whether a statute creates a private right of action is ultimately one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme

that Congress enacted into law." *Universities Research Ass'n* v. *Coutu*, 450 U.S. 754, 770 (1981), *quoting*, *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 578 (1979). *See also Transamerica Mortgage Advisors Inc.* v. *Lewis*, 444 U.S. 11 (1979). "The federal judiciary will not engraft a remedy on a statute, no matter how salutary, that Congress did not intend to provide." *California* v. *Sierra Club*, 451 U.S. 287 297 (1981). *See also Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984); *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353 (1982); *Middlesex City Sewerage Auth.* v. *Nat'l Sea Clammers Ass'n.*, 453 U.S. 1 (1981).

Moreover, when Congress amended the 1934 Act in 1975 it recognized that private claims under section 10(b) had been implied by the courts. *See Herman & MacLean* v. *Huddleston, supra* at 384-86. When it did so, Congress was expressly aware that *Wilko* had been held by numerous courts to preclude arbitration of 1934 Act claims, yet it did nothing to alter those decisions. *See* H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 91 (1975), U.S. Code Cong. & Admin. News, 1975, p. 342.

That the right of action under the 1933 Act in *Wilko* was expressly granted and the right of action under section 10(b) is implied is a distinction without a difference. It is the right to a judicial forum that is protected by section 29(a) of the 1934 Act and cannot be waived. There is no basis for removing from a section 10(b) claimant the protection guaranteed under section 29(a) without contradicting the clear intention of Congress.

2. The Difference Between the Jurisdictional Provisions of the 1933 and 1934 Acts Is Not Relevant to Whether 1934 Act Claims Are Arbitrable

In *Wilko*, this Court was concerned with the non-waivability, in advance of a dispute, of the federal judicial forum, not the choice between a state and federal forum, even though the choice between the state and federal forum was available to a plaintiff under the 1933 Act after a dispute had arisen. The issue in *Wilko* was whether section 22 and its grant of broad venue, nationwide service of process and judicial review could be waived by the parties, in advance of a dispute between them, by an agreement providing for a nonjudicial forum. Section 27 of the 1934 Act provides exclusive federal jurisdiction, not the choice between federal and state provided in section 22. This difference, far from evincing a Congressional intent that section 10(b) claims be arbitrable, shows the special solicitude of Congress for claims under that statute. If anything, it is all the more reason pre-dispute agreements to arbitrate 1934 Act claims should not be enforceable; Congress plainly intended that claims under the 1934 Act be resolved in federal courts, not state courts, and certainly not in a non-judicial forum.

3. Petitioners' Argument That the Rights and Remedies Provided to Defrauded Purchasers Under the 1934 Act Are Waivable in an Allegedly Fraudulent Arm's Length Agreement Is Without Merit

Petitioners argue that the long-standing federal policy against enforcement of agreements to arbitrate section 10(b) claims should not apply to agreements negotiated at arm's length. The argument has no basis.

In *Scherk* v. *Alberto-Culver, supra,* this Court did not rely on any distinction between an arm's length agreement, which *Scherk* involved, and other types of transactions in holding that arbitration agreements are enforceable in the context of international transactions. *Scherk* v. *Alberto-Culver, supra* at 512, n.6. Indeed, no court has relied on such a distinction to deprive a plaintiff of the right to seek redress of a section 10(b) violation in a federal court. *E.g., Greater Continental Corp.* v. *Schechter,* 422 F.2d 1100 (2d Cir. 1970). It was the international character of the transaction in *Scherk* that led this Court to withhold application of *Wilko* to the federal securities fraud claim not the nature of the transaction. *Scherk* v. *Alberto-Culver, supra,* at 515-19. Justice Douglas in his dissent in *Scherk,* while noting that the majority did not consider the bargaining strength of the parties in distinguishing *Wilko, id.* at 528, stated that:

> It could perhaps be argued that *Wilko* does not govern because it involved a little customer pitted against a big brokerage house, while we deal here with sophisticated buyers and sellers. . . . But that would miss the point of the problem. The Act does not speak in terms of "sophisticated" as opposed to "unsophisticated" people dealing in securities. The rules when the giants play are the same as when the pygmies enter the market.

Id. at 525-26.

To require enforcement of arbitration clauses when "sophisticated" purchasers of securities sue under the 1934 Act, while allowing "unsophisticated" purchasers the full benefit of the exclusive federal district court jurisdiction provided in section 27, would be an impermissible act of

judicial legislation. Congress alone should make such a nice distinction and it has not.[8] Indeed, it will be respondent's contention at trial that the arbitration clause in this contract was only one of a number of contractual provisions inserted by petitioners in an effort to deprive AFP of its lawful remedies for petitioners' fraud. Other provisions of the contract purport to limit AFP's recovery for any misrepresentations to the amount of a modest ascrow fund. Further, by using Xenon as the nominal contracting party in the agreement by which it was to be sold to AFP, petitioners sought to insulate themselves from liability for their misrepresentations. Together with those provisions the arbitration clause was an integral part of a scheme designed to evade the securities laws, a result section 29(a) of the 1934 Act is intended to prohibit. Where sellers induce a purchaser to buy their shares through fraudulent representations in the contract of sale and, in the same contract, seek to insulate themselves from liability through an arbitration clause and limitations on the amount the purchaser may recover, the agreement is hardly an "arm's length" transaction in which it would be just or consistent with the law to deprive him of the rights guaranteed by section 29(a) of the 1934 Act.

Conclusion

This Court should deny the Petition for a Writ of Certiorari. This is not an appropriate case to review the

8. Petitioners' argument that a determination that section 10(b) claims are arbitrable would relieve federal court dockets (Memorandum For The Petitioners at 19-20) must be rejected. Even assuming that the contention has merit, it is no basis for allowing arbitration in contravention of the non-waiver provisions of section 29(a).

question presented: Petitioners chose not to argue their contention that the arbitration clause is enforceable as to the section 10(b) claim in the court below and the contract of sale was entered into, and this action commenced, before this Court's *dictum* in *Byrd* questioning the applicability of *Wilko* to section 10(b) claims. Should this Court ever wish to review this question, an opinion below where the issue is argued, briefed and decided in the Court of Appeals would be more appropriate for review. Further, no conflict exists amoung the Courts of Appeals as to the unenforceability of an arbitration clause as to a section 10(b) claim or between the Second Circuit decision in this case and any decision of this Court. Moreover, the decision below was correct since the nonwaiver provision of section 29(a) of the 1934 Act does not allow arbitration of this claim and waiver of respondent's right under section 27 of the 1934 Act to a federal judicial forum.

Dated: June 2, 1986

Respectfully submitted,

STUART A. SUMMIT
Attorney for Respondent

Of Counsel:
SUMMIT ROVINS & FELDESMAN
WILLIAM A. ALPER
GERARD A. RISO

APPENDIX

§ 77l Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

§ 77r Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules or regulations of the Commission shall be void.

§ 77v The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, and 1292 of Title 28. No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against it in the Supreme Court or such other courts.